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No. 95-1402

In the Supreme Court of the United States

OCTOBER TERM, 1995

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ESTATE OF OTIS C. HUBERT, DECEASED,
C & S SOVERAN TRUST COMPANY (GEORGIA) N.A.,
A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

BRIEF FOR THE PETITIONER

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QUESTION PRESENTED

Whether, in calculating the taxable estate for the purpose of the federal estate tax, the marital and charitable deductions allowed by Sections 2055 and 2056 of the Internal Revenue Code, 26 U.S.C. 2055, 2056, are reduced by the expenses of administration of the estate.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-23a) is reported at 63 F.3d 1083. The opinion of the Tax Court (Pet. App. 26a-79a) is reported at 101 T.C. 314.

JURISDICTION

The judgment of the court of appeals was entered on September 12, 1995. A petition for rehearing with suggestion for rehearing en banc was filed on October 27, 1995, and was denied on December 5, 1995 (Pet. App. 24a-25a). The petition for a writ of certiorari was filed on March 1, 1996, and was granted on

April 29, 1996. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTES AND REGULATION INVOLVED

1. 26 U.S.C. 212 provides:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
>
> (1) for the production or collection of income;
>
> (2) for the management, conservation, or maintenance of property held for the production of income; or
>
> (3) in connection with the determination, collection, or refund of any tax.

2. 26 U.S.C. 641(b) provides:

> The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part. The tax shall be computed on such taxable income and shall be paid by the fiduciary.

3. 26 U.S.C. 642(g) provides:

> Amounts allowable under section 2053 or 2054 as a deduction in computing the taxable estate of a decedent shall not be allowed as a deduction (or as an offset against the sales price of property in determining gain or loss) in computing the taxable income of the estate or of any other person, unless there is filed, within the time and in the manner and form prescribed by the Secretary, a statement that the amounts have not been allowed

> as deductions under section 2053 or 2054 and a waiver of the right to have such amounts allowed at any time as deductions under section 2053 or 2054. This subsection shall not apply with respect to deductions allowed under part II (relating to income in respect to decedents).

4. 26 U.S.C. 2053(a) provides:

> For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts—
>
> (1) for funeral expenses,
> (2) for administration expenses,
> (3) for claims against the estate, and
> (4) for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate,
>
> as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered.

5. 26 U.S.C. 2055 provides, in relevant part:

> (a) For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate the amount of all bequests, legacies, devises, or transfers—
>
> * * * * *

(2) to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes * * *.

* * * * *

(c) If the tax imposed by section 2001, or any estate, succession, legacy, or inheritance taxes, are, either by the terms of the will, by the law of the jurisdiction under which the estate is administered, or by the law of the jurisdiction imposing the particular tax, payable in whole or in part out of the bequests, legacies, or devises otherwise deductible under this section, then the amount deductible under this section shall be the amount of such bequests, legacies, or devises reduced by the amount of such taxes.

(d) The amount of the deduction under this section for any transfer shall not exceed the value of the transferred property required to be included in the gross estate.

* * * * *

6. 26 U.S.C. 2056 provides, in relevant part:

(a) For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsections (b) and (c), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

* * * * *

(b)(4) In determining for purposes of subsection (a) the value of any interest in property passing to the surviving spouse for which a deduction is allowed by this section—

(A) there shall be taken into account the effect which the tax imposed by section 2001, or any estate, succession, legacy, or inheritance tax, has on the net value to the surviving spouse of such interest; and

(B) where such interest or property is encumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined.

7. 26 C.F.R. 20.2056(b)-4(a) provides, in relevant part:

The value, for the purpose of the marital deduction, of any deductible interest which passed from the decedent to the surviving spouse is to be determined as of the date of the decedent's death * * *. The marital deduction may be taken only with respect to the net value of any deductible interest which passed from the decedent to his surviving spouse, the same principles being applicable as if the amount of a gift to the spouse were being determined. In determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limita-

tions upon her right to income from the property. An example of a case in which this rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate.

STATEMENT

This case concerns the estate tax liability of the estate of Otis C. Hubert, who was a resident of Georgia at his death. Mr. Hubert died in 1986, leaving an estate greater than $30,000,000 (Pet. App. 3a).

1. An estate is a taxable entity that is subject to both the federal estate tax and the federal income tax. The estate tax is imposed on the taxable estate, which is the gross value of the decedent's estate at the time of death less deductions authorized by statute. 26 U.S.C. 2001, 2051. The income tax is imposed annually on the net income received by the estate from the administration of the assets of the estate during the period prior to distribution of those assets to the heirs and other claimants. 26 U.S.C. 641(b).

This case involves the "marital" and "charitable" deductions which, along with other deductions, are subtracted from the gross value of the decedent's estate at the time of death in determining the taxable estate. See 26 U.S.C. 2053-2056. Under Section 2056(a) of the Code, the "marital deduction" is the "amount equal to the value of any interest in property which passes * * * from the decedent to his surviving spouse" (26 U.S.C. 2056(a)). Similarly, the "charitable deduction" is limited to the amount of "the value of the * * * property" that is transferred

to a charitable organization (26 U.S.C. 2055(d)). The date-of-death "value" of the property in Mr. Hubert's estate that "passes" to his surviving spouse or to a charity thus passes free of the estate tax under Sections 2055 and 2056.

2. Mr. Hubert's last will was executed in 1982 and was thereafter amended by two codicils. Following his death, the provisions of the will and codicils were challenged by various interested parties. The resulting litigation was settled under an agreement that was approved by the Georgia probate court in 1990 (Pet. App. 29a). The parties to that litigation stipulated that the distribution of the estate was to be controlled by this settlement agreement, rather than by the decedent's will (*id.* at 29a-30a).

Under the terms of the settlement agreement, the residuary assets of the estate were allocated between a marital and a charitable share (Pet. App. 30a). The marital share was in turn divided between two trusts: One trust provides for the payment of income for life to the decedent's wife, with a general power of appointment to her in the remainder; the other provides for the payment of income for life to the decedent's wife, with the remainder to charity.[1] The charitable

[1] The first of these two trusts is a "GPA" trust; the second is a "QTIP" trust. A trust that qualifies for the marital deduction under Section 2056(b)(5) of the Code by giving the surviving spouse both a lifetime income interest and a general power of appointment over the corpus of the trust is referred to as a "GPA" (general power of appointment) marital trust. If the spouse has only a lifetime income interest in the trust, but the trust otherwise is a "qualified terminable interest property" (QTIP) trust by virtue of an irrevocable election, it also qualifies for the marital deduction. See 26 U.S.C. 2056(b)(7)(A)(i) and 2044. The marital deduction extends to

share of the residuary assets was distributed to a trust for the charitable beneficiaries. Under the terms of the settlement agreement, the marital and charitable shares were $13,353,572 and $12,870,864, respectively (*id.* at 74a). The administration expenses of the estate were to be allocated between the marital and charitable shares (*id.* at 30a).

3. The litigation challenging the will delayed the final administration of the estate. During the years prior to distribution of the estate's assets, the estate earned significant amounts of income—between 1986 and 1991, the estate's income exceeded $4,500,000. During this same period, the estate also incurred significant administration expenses, including attorney's fees, that exceeded a total of $2,000,000 (Pet. App. 3a).

Under Georgia probate law, an executor may charge payments of administration expenses either against the income of the estate or against its principal, if the will so provides. Ga. Code Ann. § 53-12-219(e) (Michie 1995); see Ga. Code Ann. § 53-15-3 (Michie 1982). In this case, the decedent's will authorized the executors "to charge any expenses against income or principal or apportion the same" (Pet. App. 37a). Acting pursuant to this authority, the executors charged $506,989 of the administration expenses against the principal of the estate in the state probate proceedings. As permitted by 26 U.S.C. 2053(a)(2), those charges were deducted from the gross estate in calculating the value of the taxable estate for purposes of the federal estate tax (Pet. App. 3a). All other administration expenses

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both types of trust, and the corpus of both trusts is includable in the estate of the surviving spouse.

were charged by the executors against the post-death income earned by the estate (*id.* at 37a). As permitted by 26 U.S.C. 212, these charges were deducted from the income earned by the estate during the period of administration for purposes of the federal income tax, as expenses paid for the production of income (Pet. App. 37a-39a).

Section 642(g) of the Internal Revenue Code authorizes executors to elect to deduct administration expenses either on the estate tax return or on the estate's income tax returns. 26 U.S.C. 642(g). When administrative expenses are paid from the corpus of the residuary estate left to the surviving spouse and are deducted on the estate tax return (under 26 U.S.C. 2053(a)(2)), this reduces directly the amount of property that passes to the surviving spouse, and therefore reduces directly the marital deduction under 26 U.S.C. 2056(a). *Estate of Luehrmann* v. *Commissioner*, 287 F.2d 10, 12-13 (8th Cir. 1961); *Estate of Roney* v. *Commissioner*, 33 T.C. 801, 804 (1960), aff'd per curiam, 294 F.2d 774 (5th Cir. 1961). The executors in this case accordingly reduced the amount of the marital and charitable deductions claimed on the estate tax return by the amount of the administration expenses charged against the principal of the estate. They did not, however, make such reductions in the marital and charitable deductions for the administration expenses charged against the income of the estate and deducted in the calculation of the estate's income tax pursuant to Sections 212 and 642(g) (Pet. App. 37a).

4. The Commissioner of Internal Revenue issued a notice of deficiency with respect to the estate taxes owed by the estate. The Commissioner took the position that the marital and charitable deductions of

the estate had been overstated and must be reduced by the total administration expenses paid by the estate, whether the executors elect to charge those expenses against the principal or the income of the estate (Pet. App. 30a, 37a). The estate contended that these deductions must be reduced by administration expenses only when the expenses are paid from the corpus of the estate and not when they are paid from the post-death income earned by that corpus.

5. a. In a reviewed opinion with two dissents, the Tax Court sustained the estate's position (Pet. App. 26a-79a). The court concluded that administration expenses that are charged, under state law, against estate income (rather than corpus) do not reduce the value of the property passing to the spouse and to the charity, and therefore do not reduce the marital and charitable deductions. In so holding, the court relied (*id.* at 43a) on its prior decision in *Estate of Street* v. *Commissioner*, T.C. Memo. 1988-553, which the Sixth Circuit had reversed in part (974 F.2d 723 (1992)). The Tax Court reasoned that "administration expenses come into existence only after the death of the decedent and may relate to both income and corpus" (Pet. App. 42a). The court stated that, because "administration expenses logically can be charged to either income or corpus" (*ibid.*), the allocation of those expenses under state law determines whether they are deductions from the corpus of the estate or only from the income earned by that corpus. The court concluded that, since Georgia law permits administration expenses to be allocated to income, and since the expenses involved in this case were allocated to income by the executors, these expenses do not reduce the corpus of the marital and charitable interests and therefore have no effect on the proper

value of the marital and charitable deductions (*id.* at 39a).

The Tax Court stated that the regulations adopted under Section 2056 did not alter its conclusion. Those regulations specify that (26 C.F.R. 20.2056(b)-4(a)):

> The value, for the purpose of the marital deduction, of any deductible interest which passed from the decedent to the surviving spouse is to be determined as of the date of the decedent's death[.] * * * In determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limitations upon her right to income from the property. An example of a case in which this rule may be applied is a bequest of a property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate.

The Tax Court stated that this regulation does not "mandat[e] a setoff against the marital deduction for administration expenses" but "is merely a valuation provision which requires material limitations on the right to receive income to be taken into account when valuing the property interest passing to the surviving spouse" (Pet. App. 40a). The court held that the fact that the interest of the surviving spouse is burdened by the obligation to pay administration expenses is not "a material limitation on the right to receive income that would have a significant effect on the date-of-death value of the property of the estate" (*ibid*).

The Tax Court recognized that in *Estate of Street* v. *Commissioner*, 974 F.2d at 728, the Sixth Circuit

held that administration expenses reduce the value of the property passing to the spouse, and therefore reduce the amount of the marital deduction, even when these expenses are charged to the income from the estate. The court further noted that the Federal Circuit had applied and followed *Estate of Street* in a parallel case involving the charitable deduction (Pet. App. 46a, citing *Burke* v. *United States*, 994 F.2d 1576 (Fed. Cir.), cert. denied, 114 S. Ct. 546 (1993)). The Tax Court stated that it disagreed with the reasoning of the Sixth Circuit and "decline[d] to follow its decision in *Estate of Street*" (Pet. App. 46a).

b. Judges Halpern and Beghe each wrote dissenting opinions. Judge Halpern stated that the relevant inquiry is whether the income of the estate would have been received by the surviving spouse or charitable beneficiary if that income had not been used to pay administration expenses (Pet. App. 66a). If, as in this case, it would have been, "then it follows easily that, when such income is used for administration expenses, rather than [being] received by the surviving spouse or charitable beneficiary, the value of the interest passing from the decedent to the surviving spouse or charitable beneficiary is decreased," and the marital and charitable deductions must therefore be reduced (*ibid.*). Judge Halpern stated (*id.* at 67a) that the Fifth Circuit was correct in concluding in *Alston* v. *United States*, 349 F.2d 87, 89 (1965), that:

> No amount of legalistic legerdemain can produce * * * "the principle that where expenses of administration are paid out of post-mortem income, the amount of corpus available for charity

> is not diminished by such payments * * * " as argued by the executors.

Judge Halpern further observed that the Tax Court majority fails to explain "how we might be justified in declining to take into account material limitations on a surviving spouse's right to income" and is thus inconsistent with the Treasury regulations under Section 2056 (Pet. App. 64a, citing 26 C.F.R. 20.2056 (b)-4(a)).

Judge Beghe agreed with the dissenting opinion of Judge Halpern (Pet. App. 70a). Judge Beghe noted that numerous appellate decisions, as well as academic and professional writings, have agreed with the Commissioner's interpretation of these statutory provisions (*id.* at 77a-78a). He stated that the Tax Court's inconsistent and erroneous position "stands virtually alone on this issue" (*id.* at 77a).

6. A divided panel of the Eleventh Circuit affirmed (Pet. App. 1a-23a). The majority did not explain its conclusions, electing instead to "simply attach" and adopt the relevant portion of the Tax Court opinion "as our own, as completely as if we had set it forth herein" (*id.* at 2a). The majority acknowledged that, having thus adopted the Tax Court opinion, its holding in this case "brings us in conflict with the two other circuits which have decided the issue" (*ibid.*, citing *Estate of Street* v. *Commissioner*, *supra*; *Burke* v. *United States*, *supra*). The majority added only that it agreed with the analysis of the Tax Court rather than the conflicting analysis of the Sixth and Federal Circuits in *Estate of Street* and *Burke* (Pet. App. 3a).

Judge Dubina dissented (Pet. App. 18a-23a). He explained that the majority's holding "disregards fun-

damental federal estate taxation principles in light of state law, which allows administration expenses to be paid out of post-mortem income" (*id.* at 18a). The "fundamental federal estate taxation principle[]" disregarded by the majority is that "administration expenses, although unascertained on the date of death, are deemed to accrue at the decedent's death * * * [and] 'are charges against the gross estate'" (*id.* at 18a, 19a, quoting *Burke* v. *United States*, 994 F.2d at 1581). Judge Dubina noted (Pet. App. 20a-23a) that the majority's holding is in conflict not only with the decision of the Sixth Circuit in *Estate of Street* and the decision of the Federal Circuit in *Burke*; it also conflicts with the decisions of the Fifth Circuit in *Alston* v. *United States*, 349 F.2d 87 (1965), and in *Ballantine* v. *Tomlinson*, 293 F.2d 311 (1961), which held that the marital and charitable deductions are reduced by the amount of administration expenses even when these expenses are paid from post-death income.[2]

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[2] Judge Dubina noted (Pet. App. 22a) that these older Fifth Circuit decisions are binding on the Eleventh Circuit (*Bonner* v. *City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981) (en banc)) and should have been followed as circuit precedent in this case. The majority disagreed, stating that the provisions of state law involved in the *Alston* and *Ballantine* cases differed from the Georgia probate provisions involved in this case (Pet. App. 4a n.1). As Judge Dubina pointed out (*id.* at 21a), however, *Alston* and *Ballantine* do not rely on state law but instead hold that "administration expenses must be deducted from the gross estate even though paid out of post-mortem income." 349 F.2d at 89. See 293 F.2d at 313.

SUMMARY OF ARGUMENT

This case concerns the correct application of the "marital" and "charitable" deductions under the federal estate tax. These deductions are subtracted from the gross value of the decedent's estate at the time of death in determining the taxable estate. See 26 U.S.C. 2053-2056. The "marital" deduction is the "amount equal to the value of any interest in property which passes * * * from the decedent to his surviving spouse" (26 U.S.C. 2056(a)). The "charitable" deduction is limited to "the value of the * * * property" that is transferred to a charitable organization (26 U.S.C. 2055(d)). The "value" at the date of death of the property in the estate that passes to a surviving spouse or charity thus passes free of the estate tax.

When a marital or charitable bequest is burdened by the obligation of paying estate taxes or administration expenses of the estate, those payments—whether made directly from the corpus of such bequests or from the income earned by that corpus—must be subtracted from the gross value of the bequests in determining the "real value of the gift" (*United States* v. *Stapf*, 375 U.S. 118, 126 (1963)). Sections 2055(c) and 2056(b)(4)(A) expressly require that, when the burden of paying estate taxes is placed on the marital or charitable bequest, the amount of the marital or charitable deduction must be "reduced by the amount of such taxes" (26 U.S.C. 2055(c); see 26 U.S.C. 2056(b)(4)(A)). Under Section 2056(b)(4)(B), this same reduction must occur when the marital or charitable bequest is burdened with the obligation of paying administration expenses or other claims against the estate. 26 U.S.C. 2056(b)(4)(B). As this

Court held in *United States* v. *Stapf*, 375 U.S. at 126, to arrive at "the real value" of a bequest at the date of death under Section 2056(b)(4)(B), the costs resulting from encumbrances and obligations imposed on the transfer of that bequest must be subtracted from the gross value of the gift.

At the date of death, administration expenses are an encumbrance on the gross estate even though the amount of these expenses is not then ascertainable. When, as in the present case, the decedent's will requires that administration expenses be paid from the marital or charitable bequest, and when estate income to which the marital or charitable recipient would otherwise be entitled is used to pay those expenses, "the real value of the gift" has been reduced by these payments. The applicable Treasury regulation has therefore long provided that the "net value" of the marital bequest (and therefore the amount of the marital deduction allowed by Section 2056(a)) is reduced when "the income from the property * * * is to be used to pay expenses incurred in the administration of the estate" (26 C.F.R. 20.2056(b)-4(a)). For the reasons stated in *United States* v. *Stapf*, 375 U.S. at 127 n.11, that regulation is entitled to substantial deference.

Economic logic and common sense dictate the same conclusion. The "value" of property left as a bequest includes, as one of the sticks in the bundle of rights, the stream of income from that property. If, however, the income from that property is severed and used to pay expenses of the estate, the "real value" of that property to the legatee is correspondingly diminished. This is equally true whether such expenses (i) are paid from the income earned by the corpus of the bequest or (ii) are paid directly out of the corpus with

the income retained for the benefit of the marital or charitable interest. In either situation, when the marital or charitable bequest is burdened by the obligation of paying administration expenses, the "real value" of the bequest is reduced by the amount of those expenses, and the marital or charitable deduction is therefore reduced commensurately under Sections 2055(d) and 2056(a).

ARGUMENT

ADMINISTRATION EXPENSES PAID FROM THE CORPUS OF A CHARITABLE OR MARITAL BEQUEST, OR FROM THE INCOME EARNED BY THE CORPUS ATTRIBUTABLE TO SUCH BEQUESTS, MUST BE SUBTRACTED FROM THE GROSS VALUE OF THOSE BEQUESTS IN DETERMINING THE MARITAL AND CHARITABLE DEDUCTIONS PERMITTED UNDER THE FEDERAL ESTATE TAX

An estate is a taxable entity. It is subject to both the federal estate tax and the federal income tax. The estate tax is imposed on the taxable estate, which is the gross value of the decedent's estate at the time of death less deductions authorized by statute. 26 U.S.C. 2001, 2051. The income tax is imposed annually on the net income received by the estate from the administration of the assets of the estate during the period prior to distribution of those assets to the heirs and other claimants. 26 U.S.C. 641(b).

This case concerns the correct application of the "marital" and "charitable" deductions under the federal estate tax. These deductions (along with others) are subtracted from the gross value of the decedent's estate at the time of death in determining the taxable estate. See 26 U.S.C. 2053-2056. Under Section

2056(a) of the Code, the "marital deduction" is the "amount equal to the value of any interest in property which passes * * * from the decedent to his surviving spouse" (26 U.S.C. 2056(a)).[3] Similarly, the "charitable deduction" is limited to the amount of "the value of the * * * property" that is transferred to a charitable organization (26 U.S.C. 2055(d)). Thus, the "value" of the property in Mr. Hubert's estate "which passes" to his surviving spouse or to a charity passes free of the estate tax under Sections 2055 and 2056.

The marital and charitable deductions both require a determination of the date-of-death "value" of the transferred property.[4] This case concerns the cor-

[3] The marital deduction was added to the Code in 1948. Revenue Act of 1948, ch. 168, § 361, 62 Stat. 117. It was enacted to extend to taxpayers in common law states the "estate splitting" advantage that had previously been enjoyed only by residents of community property states. H.R. Rep. No. 1274, 80th Cong., 2d Sess. 24-26 (1948) (1948-1 C.B. 241, 260-261); S. Rep. No. 1013, 80th Cong., 2d Sess. 26-29 (1948) (1948-1 C.B. 285, 303-306). See *United States* v. *Stapf*, 375 U.S. 118, 128 (1963). Although the marital deduction was originally limited to 50 percent of the value of the adjusted gross estate, Congress removed that limitation in 1981. See 26 U.S.C. 2056(a).

[4] Courts have therefore uniformly read these provisions in *pari materia*, construing the scope of the two deductions in a consistent fashion. See, *e.g.*, *Burke* v. *United States*, 994 F.2d 1576 (Fed. Cir.), cert. denied, 114 S. Ct. 546 (1993) (charitable deduction); *Alston* v. *United States*, 349 F.2d 87 (5th Cir. 1965) (charitable deduction); *Estate of Street* v. *Commissioner*, 974 F.2d 723 (6th Cir. 1992) (marital deduction); *Ballantine* v. *Tomlinson*, 293 F.2d 311 (5th Cir. 1961) (marital deduction). This Court has noted that "strong reasons urge identical construction" of "the same phrases * * * concerning the same subject matter." *Merrill* v. *Fahs*, 324 U.S. 308, 313 (1945). See

rect determination of the "value" of such bequests when they are burdened by the obligation of paying administration expenses of the estate. It is not disputed that, to the extent that payments of administration expenses or other charges against the estate are made directly from the corpus of marital or charitable bequests, the "value" of those bequests is diminished and the marital and charitable deductions are therefore reduced commensurately under Sections 2055 and 2056. See Pet. App. 37a; *Estate of Luehrmann* v. *Commissioner*, 287 F.2d 10, 12-13 (8th Cir. 1961) ("Obviously, if the administration expenses are in fact paid out of the corpus of the estate, the residue of the estate will be diminished by such payment."); *Estate of Roney* v. *Commissioner*, 33 T.C. 801, 804 (1960), aff'd per curiam, 294 F.2d 774 (5th Cir. 1961).

In this case, however, the executors elected under applicable state law to charge a portion of the administration expenses against the income earned by the corpus of the marital and charitable bequests rather than directly against the corpus of those bequests. The question presented is whether the obligation imposed upon the marital and charitable bequests to pay administration expenses reduces the "value" of those bequests—and therefore the amount of the permitted deductions under Section 2055 and 2056—when the actual payment of the expenses is

also *Crawford Fitting Co.* v. *J.T. Gibbons, Inc.*, 482 U.S. 437, 445 (1987). The legislative history of the estate tax reflects that Congress intended that the same principles would apply in determining the "value" of marital and charitable bequests for purposes of these deductions. See page 21 & note 5, *infra*.

made from the income, rather than the corpus, attributable to those bequests.

1. This is the fourth case in which this Court has been called upon to determine whether the marital and charitable deductions under the federal estate tax are reduced by a burden placed on the bequest that reduces its "value." In the first of these cases, the Court addressed whether estate taxes that were required to be paid from a charitable bequest reduced the value of the charitable bequest and therefore reduced the charitable deduction under the estate tax. In *Edwards* v. *Slocum*, 264 U.S. 61 (1924), the Court held that the burden of paying such taxes should not be considered in valuing the charitable bequest or the taxable estate because the tax is imposed on "the interest which ceased by reason of the death" rather than on the "interest to which some person succeeds on a death." *Id.* at 63, quoting *Knowlton* v. *Moore*, 178 U.S. 41, 49 (1900).

Congress disapproved of the reasoning and the conclusion of *Edwards* v. *Slocum* and enacted, as a curative provision, what is now Section 2055(c) of the Code. That Section specifies that, when the burden of paying estate taxes is placed on a charitable bequest, the gross value of that bequest as of the date of death must be "reduced by the amount of such taxes" in determining the charitable deduction. 26 U.S.C. 2055(c). In *Harrison* v. *Northern Trust Co.*, 317 U.S. 476, 481 (1943), when the same issue arose again, the Court acknowledged that Section 2055(c) had been enacted to overrule the decision in *Edwards* v. *Slocum*. The Court explained that the new statute sought to ensure that, when the obligation to pay taxes is placed on a charitable bequest, the charitable deduction must be reduced because that obligation

"actually reduce[s] the amount of such bequest" (317 U.S. at 480, quoting H.R. Rep. No. 708, 72d Cong., 1st Sess. 49 (1932)).

When Congress enacted the marital deduction in 1948, the same limitation that had previously been enacted for the charitable deduction in Section 2055(c) was incorporated into what is now Section 2056(b)(4)(A) of the Code. See note 3, *supra*. That Section specifies that, "[i]n determining * * * the value of any interest in property passing to the surviving spouse for which a deduction is allowed by this section[,] * * * there shall be taken into account the effect which the [federal estate] tax * * *[,] or any * * * inheritance tax, has on the net value to the surviving spouse of such interest * * *." 26 U.S.C. 2056(b)(4)(A).[5]

As part of that same legislation, Congress also sought to express the underlying principle in a broader context—enacting an additional, more general provision based upon principles that are "generally applicable in determining the net value of any gift or bequest." S. Rep. No. 1013, 80th Cong., 2d Sess., Pt. 2, at 6 (1948). That provision, which is now Section 2056(b)(4)(B) of the Code, specifies that (26 U.S.C. 2056(b)(4)(B) (emphasis added)):

> *In determining for purposes of [Section 2056(a)] the value of any interest in property passing to the surviving spouse* for which a deduction is allowed by this section * * * *where such interest or property is encumbered in any manner*, or

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[5] Congress noted that the provisions of Section 2056(b)(4)(A) are "substantially the same" as the charitable deduction provisions (Section 2055(c)) upon which they are modeled. S. Rep. No. 1013, *supra*, Pt. 2, at 6.

> where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, *such encumbrance or obligation shall be taken into account* in the same manner as if the amount of a gift to such spouse of such interest were being determined.

The history of Section 2056(b)(4)(B) explains its broad purpose. The statute seeks to ensure that, when expenses must be paid from property bequeathed to the surviving spouse, the burden of paying those expenses will be treated as a reduction in the value of that bequest and, therefore, a reduction in the marital deduction permitted by Section 2056(a). See S. Rep. No. 1013, *supra*, Pt. 2, at 6. The legislative history expressly states that this same result is required whether the expenses are paid from the corpus, or from the income attributable to the corpus, of the marital bequest (*ibid.*):

> If the decedent by his will leaves the residue of his estate to the surviving spouse and she pays, or if the estate income is used to pay, claims against the estate so as to increase the residue, such increase in the residue is acquired by purchase and not by bequest. Accordingly, the value of any such additional part of the residue passing to the surviving spouse cannot be included in the amount of the marital deduction.

In *United States* v. *Stapf*, 375 U.S. 118 (1963), the Court interpreted and applied the text of Section 2056(b)(4)(B). The estate in *Stapf* contended that the statutory phrase "incumbrance or obligation" referred only to "a payment to be made *out of* property passing to the surviving spouse" (375 U.S. at 126). Under that interpretation, since the property that

the widow was required to surrender to obtain the bequest in *Stapf* did not come "out of" the property passing to her under the will but, instead, from property she already possessed, the estate contended that the payment did not reduce the amount of the marital deduction.

This Court rejected that contention. The Court explained that "the statute speaks of an obligation '*with respect* to the passing' " of the bequest (375 U.S. at 126). Since the widow's obligation was incurred "with respect to" the bequest made to her, the marital deduction had to be reduced by the costs incurred in disposing of that burden. *Ibid.* The Court explained that the statute is designed to ensure that the amount of the marital deduction is "the net economic interest received by the surviving spouse." *Ibid.* Any encumbrance or obligation imposed on the marital bequest must be subtracted from the gross value of that bequest to determine the "real value" of the bequest—and therefore to determine the permissible marital deduction under Section 2056(a). 375 U.S. at 126. See also *id.* at 129 ("the value of a conditional bequest to a widow should be the value of the property given to her less the value of the property she is required to give to another"). The Court explained that, in determining the proper scope of the deduction allowed under Section 2056(a) for the "value" of a bequest made to a spouse, "[t]he appropriate reference * * * is not to the value of the gift moving from the deceased spouse but to the net value of the gift received by the surviving spouse." 375 U.S. at 125.

In the present case, the marital and charitable bequests are burdened by the prior obligation of paying administration expenses. Just as in *Stapf*, the marital deduction must be reduced by the costs im-

posed by that obligation to determine the "real value" of the bequest and thus the permissible marital deduction under Section 2056(a).

2. Prior to the decision in the present case, the courts of appeals consistently and properly relied on the text and history of Section 2056(b)(4)(B) and on this Court's decision in *United States* v. *Stapf* in reaching this same conclusion. See, *e.g.*, *Burke* v. *United States*, 994 F.2d 1576, 1581-1582 (Fed. Cir.), cert. denied, 114 S. Ct. 546 (1993); *Estate of Street* v. *Commissioner*, 974 F.2d 723, 726 (6th Cir. 1992); *Ballantine* v. *Tomlinson*, 293 F.2d 311, 313 (5th Cir. 1961); note 4, *supra*.

a. The federal estate tax is a tax imposed on the transfer of the decedent's estate. 26 U.S.C. 2001(a); see *Riggs* v. *Del Drago*, 317 U.S. 95, 97 (1942); *Ithaca Trust Co.* v. *United States*, 279 U.S. 151, 155 (1929); *Y.M.C.A.* v. *Davis*, 264 U.S. 47, 50 (1924). Because administration expenses are necessarily incurred in the transfer of a decedent's estate, and are to be paid from the assets of the estate, they are an encumbrance on the gross estate that exists at the date of death, even though the amount of these expenses is not then ascertainable.[6] When that encumbrance falls upon the portion of the estate that comprises the marital or charitable bequest, it reduces the "real value" of that bequest and therefore reduces the marital or charitable deduction under Sections 2055 and 2056. See *United States* v. *Stapf*,

[6] Treasury regulations define "administration expenses" as "such expenses as are actually and necessarily, incurred in the administration of the decedent's estate; that is, in the collection of assets, payment of debts, and distribution of property to the persons entitled to it." 26 C.F.R. 20.2053-3(a).

375 U.S. at 126 (the value of a marital bequest that is subject to an encumbrance must reflect the "net economic interest received by the surviving spouse").

As the court of appeals stated in *Ballantine* v. *Tomlinson*, 293 F.2d at 312-313:

> At the decedent's death his estate had the obligation of paying estate taxes, debts, charges and expenses of administration. * * * It follows then that the legacy to the decedent's spouse * * * was charged, at his death, with a like part of the expenses of administration, even though the amount of such expense might not be then ascertainable.

Accord *Alston* v. *United States*, 349 F.2d 87, 88 (5th Cir. 1965); *Estate of Roney* v. *Commissioner*, 33 T.C. at 804 (fact that administration expenses are paid from post-death income does "not relieve the residuary legacy, for valuation purposes, of that burden or encumbrance for such expenses which existed at the time of death"). Chief Judge Nies correctly stated for the court in *Burke* v. *United States*, 994 F.2d at 1581 (footnote omitted), that:

> when a decedent dies, a finite amount known as the gross estate is legally created. Any deductions for expenses incurred in administering the estate are theoretically derived from this amount and, regardless of the actual source of payment, must be accounted for within the gross estate.
>
> * * * * *
>
> Section 2051 defines the taxable estate and the deductions used to determine the taxable estate in terms of the gross estate. * * * Likewise,

section 2053, by its plain language, defines the deduction for administrative expenses in terms of the gross estate. Reading sections 2031, 2051, and 2053 together, the gross estate, which is the value of the decedent's estate at the time of death, is the sole source from which the administrative expenses may be deducted. Thus, the deduction of administrative expenses as provided for by federal law—as opposed to the actual payment of administrative expenses as allowed under state law—must come from, i.e., be accounted for within, the gross estate.

b. In the present case, however, the courts below disregarded the case law that had consistently held that administration expenses are an encumbrance on the gross estate that exists at the date of death. Instead, they reasoned that, because "[a]dministration expenses are incurred and accrue during administration" (Pet. App. 6a, 39a), these expenses "may relate to both income and corpus" and "logically can be charged to either" (*id.* at 10a, 42a).

The fact that administration expenses are inevitably incurred after the date of death, however, is not relevant in determinining the "real value" of the marital and charitable bequests on the date of death. On the date of death, the marital and charitable bequests in this case were subject to the requirement that, when administration expenses were thereafter incurred, they would be paid from those bequests. At the date of decedent's death, the estate (and, in particular, the marital and charitable bequests) could not be transferred without incurring and paying administration expenses. Administration expenses represent an encumbrance on the gross estate, and on

the marital and charitable bequests that are burdened by the obligation of paying such charges, for they must be paid before the property of the estate may be transferred.

When, as in this case, administration expenses are an "encumbrance or obligation" (26 U.S.C. 2056(b)(4)(B)) on the marital and charitable bequests, the costs incurred in disposing of that obligation must be subtracted from the gross value of those bequests to determine the "real value" or the "net economic interest received by the surviving spouse" and charity (*United States* v. *Stapf*, 375 U.S. at 126). If estate income to which the marital or charitable recipient is otherwise entitled is used to pay such administration expenses, the value of the marital and charitable bequests has, to the extent of those payments, been "acquired by purchase and not by bequest," and the marital and charitable deductions must be reduced accordingly (S. Rep. No. 1013, *supra*, Pt. 2, at 6). See page 22, *supra*.

c. Economic logic and common sense dictate the same conclusion. The "value" of property left as a bequest includes, as one of the sticks in the bundle of rights, the right to receive the stream of income derived from that property. If, however, that income is severed and must be used to pay expenses of the estate, the "real value" (*United States* v. *Stapf*, 375 U.S. at 126) of that property to the legatee is correspondingly diminished.

Consider, for example, an estate with a gross value of $1,000,000 on the date of death, $100,000 of which is to pass to a specified heir, with the residuary interest to pass equally to a surviving spouse and a charity. Assume that, as in the present case, the expenses

of administration are charged against the residuary estate. Assume further that administration expenses of $50,000 are incurred and paid on the first anniversary of the decedent's death. In order to pay those administration expenses, the executor could set aside a portion of the residuary estate on the date of death and pay the expenses from that severed portion when the expenses come due. That would, of course, directly diminish the "value" of the residuary interest on the date of death. The "value" of the residuary interest on the date of death is thus not $900,000 but is $900,000 *less* the funds that, if set aside on that date, would pay the administration expenses as they come due.

This same conclusion holds if, instead of segregating the residuary "corpus" for that purpose, the executor thereafter takes part of the earnings of the corpus to pay the administration expenses. In either case, the present or "real value" (*United States* v. *Stapf*, 375 U.S. at 126) at the date of death of the property that ultimately passes to the spouse and the charity is less than the unencumbered sum of $900,000 as of that date. Because the value of the residuary estate that passes to the spouse and charity is encumbered by the obligation to pay administration expenses, the expenses incurred in meeting that obligation must be subtracted from the theoretical, unencumbered value of the property in determining the proper amount of the marital deduction. See 26 U.S.C. 2056(b)(4)(B); *Burke* v. *United States*, 994 F.2d at 1581; *Estate of Street* v. *Commissioner*, 974 F.2d at 726.

As the Fifth Circuit stated in *Alston* v. *United States*, 349 F.2d at 89:

> No amount of legalistic legerdemain can produce * * * "the principle that where expenses of administration are paid out of post-mortem income, the amount of corpus available for charity is not diminished by such payments * * *" as argued by the executors.

3. a. Treasury regulations have long mandated this same conclusion. The regulations specify that any "material limitation" on the right of a spouse to receive income earned by the corpus of the marital bequest reduces the "value" of that bequest and therefore commensurately reduces the marital deduction under Section 2056(a). 26 C.F.R. 20.2056(b)-4(a). The regulations illustrate that principle by an example that directly governs the present case (*ibid.*):

> An example of a case in which this rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate.

This regulation was adopted in 1958 (T.D. 6296, 1958-2 C.B. 432, 568). It is virtually identical to the original regulation that was promulgated in 1949, the year following enactment of the statute (14 Fed. Reg. 2623, 2634 (1949)).

As Judge Dubina noted in his dissent in this case (Pet. App. 22a), and as the Fifth Circuit explained in *Ballantine* v. *Tomlinson*, 293 F.2d at 313, the Com-

missioner's interpretation of Section 2056 is directly supported by the legislative history of the statute. That history specifies that, when the spouse directly pays, or "estate income is used to pay, claims against the estate," the marital deduction must be reduced by the amount of such payments.[7] S. Rep. No. 1013, *supra*, Pt. 2, at 6; see page 22, *supra*. The regulation is also directly supported by the conclusion of this Court in *United States* v. *Stapf*, 375 U.S. at 126, that the costs imposed by burdens placed upon a marital bequest must be subtracted from the gross value of the bequest "to arrive at the real value of the gift" for purposes of the marital deduction.

b. The Tax Court sought to belittle the significance of this regulation, stating that it is "merely a valuation provision" (Pet. App. 40a). The court stated that the payment of administration expenses from income does not result in a "material" impairment of the right of the marital bequest to receive income if the amount of such expenses is "insubstantial" in comparison to the amount of the income (*id.* at 42a).[8]

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[7] As Judge Dubina noted (Pet. App. 22a), and as the Fifth Circuit held in *Ballantine* v. *Tomlinson*, the term "claims" in this legislative history necessarily encompasses administration expenses: "The reason for including the one applies to the other." 293 F.2d at 313. See also *Estate of Street* v. *Commissioner*, 974 F.2d at 728; *Estate of Horne* v. *Commissioner*, 91 T.C. 100, 109-110 (1988); *Estate of Roney* v. *Commissioner*, 33 T.C. at 805; Rev. Rul. 73-98, 1973-1 C.B. 407.

[8] The Tax Court also suggested (Pet. App. 41a) that, in Revenue Ruling 69-56, 1969-1 C.B. 224, the Treasury had ruled that an obligation placed on a marital bequest to pay administration expenses does not result in "diminution of the marital deduction." That ruling, however, expressly addressed only whether "the *inclusion of such powers* or directions *in the governing instrument* * * * [would] result in the disallowance or diminution of the marital deduction." *Ibid.* (emphasis added). It did not, as the Tax Court implied, address whether the actual payment of such administration expenses out of the corpus or income of the marital bequest would require a reduction in the marital deduction. Since the enactment of Section 2056(b)(4)(B) in 1948, however, the applicable Treasury regulations have consistently and expressly provided that, when "the income from the property * * * is to be used to pay expenses incurred in the administration of the estate," the marital deduction must be reduced by the amount of such payments. 26 C.F.R. 20.2056(b)-4(a).

The court stated that the administration expenses involved in this case were "insubstantial" and therefore did not effect a "material" impairment of the right to receive income within the meaning of the regulation (*ibid.*).

The regulation, however, specifies that the marital deduction must be reduced whenever administration expenses have been paid from post-death income, regardless of the exact amount of the expenses in relation to the income. See *Estate of Street* v. *Commissioner*, 974 F.2d at 728 ("The example set forth in the regulation states that income used to pay the expenses of administration must reduce the size of the marital deduction"); *Fisher* v. *United States*, 28 Fed. Cl. 88, 93 (1993). Under the plain text of the regulation, it is the burden of paying administration expenses *itself* that constitutes the "material" limitation on the right of the marital bequest to receive the income from the estate. By any logical reckoning, moreover, the administration expenses involved in this case were far from "insubstantial," for they exceeded $2,000,000 (Pet. App. 3a).

c. The Tax Court also erred in stating (Pet. App. 39a) that the amount of the permissible federal estate

tax deductions depends on whether state law permits administration expenses to be charged to post-death income. Although state law defines the nature of property rights, federal law determines the manner and extent to which such rights are taxed. *Morgan* v. *Commissioner*, 309 U.S. 78, 80 (1940); *Burnet* v. *Harmel*, 287 U.S. 103, 110 (1932); *Burke* v. *United States*, 994 F.2d at 1580; *Murray* v. *United States*, 687 F.2d 386, 392 n.3 (Ct. Cl. 1982). As this Court explained in *Lyeth* v. *Hoey*, 305 U.S. 188, 194 (1938):

> In dealing with the meaning and application of an act of Congress enacted in the exercise of its plenary power under the Constitution to tax income and to grant exemptions from that tax, it is the will of Congress which controls, and the expression of its will, in the absence of language evidencing a different purpose, shall be interpreted "so as to give a uniform application to a nationwide scheme of taxation." Congress establishes its own criteria and the state law may control only when the federal taxing act by express language or necessary implication makes its operation dependent upon state law [citations omitted].

In the present case, the relevant Sections of the Internal Revenue Code do not "by express language or necessary implication make[] its operation dependent upon state law" (*ibid.*). Instead, as the Federal Circuit explained in *Burke* v. *United States*, 994 F.2d at 1581, "[a]lthough section 2053 permits state law to determine what admininistrative expenses are 'allowable,' how section 2053 treats the allowable administrative expenses for estate tax deduction purposes is a federal question." See also *Estate of Street* v. *Commissioner*, 974 F.2d at 728.

The question in this case does not turn on how the executor has allocated the expenses or on how state law permits such expenses to be allocated. Instead, it turns on how the burden of paying such expenses—either from the corpus or income attributable to the bequest—affects the "value" of the bequest at the date of death and thus the permissible marital and charitable deductions. 26 U.S.C. 2055(d), 2056(a).

d. The Treasury's interpretation of the governing federal statutes is entitled to substantial deference. As this Court stated in upholding another portion of this same regulation in *United States* v. *Stapf*, "[t]his Court has frequently 'given considerable and in some cases decisive weight to . . . interpretative Regulations of the Treasury and of other bodies that were not of adversary origin.'" 375 U.S. at 127 n.11, quoting *Skidmore* v. *Swift & Co.*, 323 U.S. 134, 140 (1944). Moreover, when "a Treasury Regulation * * * is supported by declarations of congressional intent," it "is particularly persuasive" (*ibid.*). In the present case, the applicable legislative history—like the regulation—contains a plain statement that, when estate income is used to pay burdens imposed on the marital bequest, the value of the bequest must be reduced by the amount of such payments (S. Rep. No. 1013, *supra*, Pt. 2, at 6). See 26 C.F.R. 20.2056(b)-4(a).

In *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 476 (1979), quoting *United States* v. *Cartwright*, 411 U.S. 546, 550 (1973), quoting *United States* v. *Correll*, 389 U.S. 299, 307 (1967), the Court noted that it:

> customarily defers to the regulation, which "if found to 'implement the congressional mandate in some reasonable manner,' must be upheld."

The applicable regulation adopted by the Treasury under Section 2056(b)(4)(B) represents a contemporaneous and "reasonable" interpretation of the statute. The regulation therefore "deserves deference" in this case (*Smiley* v. *Citibank (South Dakota), N.A.*, No. 95-860 (June 3, 1996), slip op. 9.[9]

Moreover, even if an ambiguity were thought to exist, the estate cannot prevail simply by "casting some doubt on the proper construction of the statute." *United States* v. *Stewart*, 311 U.S. 60, 71 (1940). As this Court has frequently stated (*New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440 (1934)):

> Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.

Accord *Deputy* v. *DuPont*, 308 U.S. 488, 493 (1940). Statutory provisions that authorize deductions are to be "construed narrowly," and any ambiguity in their application is to be resolved against the asserted deduction. *United States* v. *Stewart*, 311 U.S. at 71.

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[9] Deference is afforded to the Commissioner's interpretation of the internal revenue laws because (*National Muffler Dealers Ass'n* v. *United States*, 440 U.S. at 477):

> "Congress has delegated to the * * * Commissioner [of Internal Revenue], not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code. 26 U.S.C. § 7805(a)." *United States* v. *Correll*, 389 U.S. at 307. That delegation helps ensure that in "this area of limitless factual variations," *ibid.*, like cases will be treated alike. It also helps guarantee that the rules will be written by "masters of the subject," *United States* v. *Moore*, 95 U.S. 760, 763 (1878), who will be responsible for putting the rules into effect.

See also *Commissioner* v. *Schleier*, 115 S. Ct. 2159, 2163 (1995).

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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